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No. 871

In the Supreme Court of the United States

OCTOBER TERM, 1967

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ~~COLORADO~~ Wyoming, PETITIONER,

v.

RALPH E. BARBY AND MARIE BARBY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

ERWIN N. GRISWOLD,
Solicitor General,
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INDEX

	Page
Opinions Below	1
Jurisdiction	1
Question Presented	2
Statute Involved	2
Statement	3
Reasons for Granting the Writ	4
Conclusion	10
Appendix	11

CITATIONS

Cases:

Anderson v. *Helvering*, 310 U.S. 404 3

Commissioner v. *P. G. Cake, Inc.*, 356 U.S. 260 ..... 3, 4, 5, 6, 9

Estate of Killam, 33 T.C. 345 8

Floyd v. *Commissioner*, 309 F. 2d 95 (C.A. 5) 6, 7, 8, 9

United States v. *Foster*, 324 F. 2d 702 (C.A. 5) 6, 7, 8, 9

Statutes:

28 U.S.C. 1254 2

Internal Revenue Code of 1954, Section 1221 2-3

283-705—67



In the Supreme Court of the United States

OCTOBER TERM, 1967

No. ——

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ~~COLUMBIA~~ OKLAHOMA, PETITIONER

v.

RALPH E. BARBY AND MARIE BARBY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of Earl R. Wiseman, Director of Internal Revenue for the District of Oklahoma, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, which became final on July 5, 1967.

OPINIONS BELOW

The opinion of the district court (R. 106–114)[1] is not officially reported. The opinion of the court of appeals (App. 11–15 *infra*) is reported at 380 F. 2d 121.

JURISDICTION

The judgment of the court of appeals was entered on July 5, 1967. By order dated September 29, 1967,

[1] "R." references are to the pages of the original appellate record; "App." references are to the appendix to this petition.

Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including December 2, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

As grantors of an oil and gas lease, respondents reserved a one-eighth royalty and a $300,000 oil payment which was expected to pay out, as it did, in a few years. Then, while retaining the royalty, they assigned the production payment, in equal halves to third parties for $150,000 for each half. The question presented is whether the $300,000 received for the assignment of the production payment was capital gain, as the court below held, or ordinary income subject to the depletion allowance, as petitioner contends.

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 1221. Capital Asset Defined.

For the purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade of business, of a character which is subject to the

allowance for depreciation provided in section 167, or real property used in his trade or business;

* * * * * *

(26 U.S.C. 1964 ed., Sec. 1221.)

STATEMENT

Respondents owned land having deposits of oil and gas. On November 5, 1956, they leased this land to Cabot Carbon Company, reserving a one-eighth royalty and an oil payment of $300,000 payable out of production from 90 percent of the lessee's working interest.[2] On the same day, they conveyed a one-half interest in the $300,000 production payment to Eby, Inc., for $150,000, and on January 3, 1957, they conveyed the other one-half to Today Oil Company for $150,000. (R. 22–23.) Taxpayers retained their royalty interest, to run for the life of the mineral property or until production ceased.

At the time of the lease the land was not producing oil and gas; wells had not been drilled. However, respondents, their lessees, and the assignees of the oil payment believed from the outset that the oil payment would pay out within a few years. Respondents stipulated at trial that this belief would be shared by any person of ordinary prudence dealing in mineral lands

[2] An oil payment is "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced", whereas a royalty is not limited to a specified sum of money but is "a right to receive a specified percentage of all oil and gas produced" for the entire term of the lease. *Anderson* v. *Helvering*, 310 U.S. 404, 409–410; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 262.

or mineral leases with knowledge of the facts then generally known or ascertainable upon reasonable inquiry. The oil payment did in fact pay out within the estimated time (R. 22–23).

Respondents reported their share of the gain from the sales of the two undivided interests in the production payment as long-term capital gain for 1956 and 1957 (R. 24). The Commissioner of Internal Revenue determined that the gain was properly reportable as ordinary income, subject to the depletion allowance, and asserted tax deficiencies (R. 3). Respondents paid the deficiencies, filed a timely refund claim, and brought a timely suit for refund against the district director after the refund claim was denied (R. 1–2).

The district court ruled that the gain was capital (R. 104, 106–114), and the court of appeals affirmed (App. *infra.*)

REASONS FOR GRANTING THE WRIT

The ruling below is in conflict with a decision of this Court and decisions of the Court of Appeals for the Fifth Circuit. It creates, moreover, substantial opportunities for improper conversion of ordinary income into capital gain, in a way that would result in inconsistent tax treatment of taxpayers residing in the Fifth and Tenth Circuits.

1. The decision conflicts with *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260. There, five taxpayers carved oil (and sulphur) production payments out of royalty or working interests they owned, and transferred them in consideration of specified cash payments, equivalent

to the value of the transferred production payments. The taxpayers retained royalties or working interests that would continue until the minerals were exhausted or production ceased. As to one taxpayer the Court noted that (p. 262): "At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years." Indeed, as to all five cases the Court stressed (p. 265) that the payout "could be ascertained with considerable accuracy." Thus it was clear that each taxpayer had assigned the right to receive monies that, in his hands, would clearly have been ordinary income.

The Court concluded (p. 264) that "the consideration received for these oil payment rights (and the sulphur payment right) was taxable as ordinary income, subject to depletion". This ruling controls here. The parties have stipulated that respondents and their assignees reasonably believed at the outset that the oil payment would pay out, as it did, within a few years. This was reflected in the assignees' payment of $300,000 cash for a $300,000 oil payment. As in *Lake*, only a fraction of respondents' oil rights were transferred; the balance was retained in the form of a royalty for the life of the mineral property or until production ceased. As this Court said in *Lake* (p. 266):

> The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise

obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

The court of appeals distinguished *P. G. Lake* on the ground that the taxpayers there "conveyed neither the whole nor an undivided fraction of the oil production payment, but rather retained a reversionary interest therein". In fact, however, the taxpayers in *Lake,* like respondents here, did convey all rights to a production payment, while retaining the royalty interest. This Court concluded in *Lake* that there had been no conversion of a capital asset because the taxpayer assigned only a fraction of the more extensive mineral interests it held—a fraction the payout of which could be ascertained with reasonable accuracy. This rationale is equally applicable here, and the court below erred in not so holding.[3]

2. The present decision is also in conflict with two decisions of the Fifth Circuit, *United States* v. *Foster,* 324 F. 2d 702, and *Floyd* v. *Commissioner,* 309 F. 2d 95. Both of these cases involved an assignment of an oil payment by a taxpayer who retained a royalty; in both there was a reasonable expectation of full payout from production. In both the Fifth Circuit, relying upon *Lake,* held that the payments re-

[3] The fact that the production payment in *Lake* was carved out subsequently to the creation of the transferor's working interest while the production payment in this case was created simultaneously with the respondents' royalty is without significance under the rationale of *Lake.*

ceived for the assignments were ordinary income to the assignor, subject to the depletion allowance.

In *Floyd,* as here, the taxpayer was the lessor of oil and gas land, and the lease reserved to him a royalty and a separate oil payment, which he subsequently assigned. The Fifth Circuit held that the assignment generated depletable ordinary income rather than capital gain. *Floyd* v. *Commissioner, supra.*

In form, *Foster* differed. There the lease reserved to the taxpayer and his co-lessors what was termed a 10/24ths "royalty" interest until $220,000 was paid, and thereafter a 5/24ths royalty. The lessors assigned an oil payment (also designated a "royalty") of $110,000 out of 5/24ths of production. In reaching the same conclusion as in *Floyd,* the Fifth Circuit deemed irrelevant the question whether, in a given case, the assigned oil payment was formally or conceptually separate from the retained royalty in the hands of the assignor. The legally significant fact, the court held, is that the oil payment was carved out from the sum of the interests the taxpayer purported to reserve under a single lease. The court reasoned that (324 F. 2d at p. 708):

> in finding that the assigned oil payment was carved out of taxpayer's depletable property interest, all the mineral interests which taxpayer retained underlying this one tract of land and subject to a single lease, under tax law principles, are to be considered as one interest. Prior to execution of the lease, taxpayer and his co-lessors had full, perfect ownership of the land. By leasing it, they created another property interest for the benefit of the lessee, but

> the interest they retained continued as one interest. A landowner conceivably might purport to retain a thousand separate interests, although in reality what he has held back is but one reserved interest with various types of divisions or units. * * *

The court regarded only one other issue as significant—whether there was a reasonable expectation of full payout at the time an oil payment was assigned. If so, the court held, the oil payment is a terminable interest limited to the specified payout—not an interest extending over the entire life of the lease, such as a royalty. Taking into account all of the relevant facts—including the fact that (p. 709) "the purchasers of the $110,000 oil production payment paid $100,882.35 for it, a discount of less than 10 per cent"—the court concluded that the initial expectation of full payment was wholly reasonable. Accordingly, the court held that the considerations for the assignment of the oil payment were ordinary depletable income to the assignors.[4]

In the decision below, the Tenth Circuit sought to distinguish *Floyd* and *Foster*, but the asserted factual distinctions are based on a rejection of the principles underlying the Fifth Circuit's decisions. The court stated that in *Floyd* (App. 14) "there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of

[4] Accord *Estate of Killam*, 33 T.C. 345.

the assigned oil payment contingent upon production". Apparently the court referred to the assignor's agreement to repurchase a portion of the oil payment, at the request of the assignee, if the number of producing wells, 15 at the time of assignment, was not increased to 21. But in *Foster* the Fifth Circuit expressly refused to find that this fact controlled *Floyd* (324 F. 2d at 707): "This agreement did not reduce the transaction to something less than a complete divestiture of ownership of the oil payment."

The attempt to distinguish *Foster* as a case where (App. 13) "the taxpayer sold only a portion of a reserved 'royalty' interest" is directly contrary to the rationale of the *Foster* decision that the transfer of a "royalty" was in substance the transfer of a production payment.

3. The Tenth Circuit, in ignoring the thrust of this Court's decision in *P. G. Lake,* has approved a method that would allow lessors of oil and gas land to secure capital gains on the assignment of production payments, which have been carved out of a larger interest. The Fifth Circuit, another jurisdiction where there is a large amount of oil and gas production, has reached the contrary conclusion in cases indistinguishable from the present one. Thus, the decision below, if allowed to stand, poses an important threat to the revenues, and presents a significant probability that similarly situated taxpayers will receive inconsistent treatment in the Fifth and Tenth Circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1967.

APPENDIX

United States Court of Appeals—Tenth Circuit

(No. 9094—May Term—1967.)

Appeal From the United States District Court for the Western District of Oklahoma

Earl R. Wiseman, Director of Internal Revenue for the District of Oklahoma, appellant

v.

Ralph E. Barby and Marie Barby, Husband and Wife, appellees

Before Murrah, Chief Judge, and Pickett and Hickey, Circuit Judges.

Pickett, Circuit Judge.

This is a tax refund case originating in the United States District Court for the Western District of Oklahoma. The sole question is whether taxpayers' gain from two sales of undivided one-half interests in an oil production payment is taxable as long-term capital gain or as ordinary income. 26 U.S.C. §§ 1221, 1222. Judgment was entered for the taxpayers, Ralph E. and Mary Barby, husband and wife.

The facts are fully stipulated. On November 5, 1956, taxpayers executed oil and gas leases on a large tract of Oklahoma land which they had owned for several years and on which there was then no production. Under the lease agreement, taxpayers reserved a one-eighth royalty interest and a $300,000 oil production payment to be paid out of 90% of the lessee's 7/8ths working interest. On the same day, November 5,

1956, taxpayers sold a one-half interest in the oil production payment to a third party for $150,000. On January 3, 1957, they sold the remaining one-half interest to another party for $150,000, retaining their one-eighth royalty interest.

In their joint returns for 1956 and 1957, taxpayers reported the proceeds from the sale of the oil production payment as long-term capital gain. The Commissioner of Internal Revenue determined that the proceeds from this sale were ordinary income, subject to depletion allowance, and accordingly asserted tax deficiencies for 1956 and 1957. Taxpayers paid the deficiencies, with interest, and filed a refund claim which was denied. Thereupon this action was brought against the District Director.

The District Director asserts that the capital assets here consist of the entire reserved economic interest in the oil in place, so that when taxpayers leased the land and reserved a royalty interest and an oil production payment and then subsequently sold the oil production payment alone, they transferred less than their entire economic interest in the oil in place and therefore did not sell a capital asset, but rather the right to receive future ordinary income. We apprehend no reason for such a broad principle, nor do we think the decisions relied upon sustain the District Director's position.

Primary reliance is placed upon Commissioner v. P. G. Lake, Inc. 356 U.S. 260, rehearing denied 356 U.S. 964. Lake was a corporation engaged in the business of producing oil and gas. It had a ⅞ths interest in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000, and in consideration of his cancellation of the debt assigned an oil payment right (production payment) to him in the amount of $600,000, payable

out of 25% of the oil attributable to its working interest in the two leases. The assignment provided that the conveyance would thereafter terminate and that the interest assigned "shall revert to and revest in the grantor. . . ." It was held that the consideration received for the assignment was taxable as ordinary income subject to depletion allowance, and not as long-term capital gain. It is apparent that the Lake case dealt with a factual situation in which the taxpayer conveyed neither the whole nor an undivided fraction of the oil production payment, but rather retained a reversionary interest therein upon satisfaction of the $600,000 debt. The purchaser received nothing except the right to receive the oil payment until the debt was satisfied. Here, taxpayers disposed of their entire interest in the reserved oil production payment, a property distinct and separate from the royalty interest, and a property in which taxpayers retained no reversionary interest. Other cases cited by the District Director in support of his position are also distinguishable. In United States v. Foster, 5 Cir., 324 F.2d 702, the taxpayer sold only a portion of a reserved "royalty" interest. In Floyd v. C.I.R., Cir., 309 F.2d 95, there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of the assigned oil payment contingent upon production. In Estate of Killam, 33 T.C. 345, the taxpayer sold only the first of two successive oil payments which he had reserved. In Floyd and Killam, as well as Lake, there was production from the property at the time of the assignment, and this production could be applied to pay-out the assigned oil payment.

The retention of an economic interest in oil property is not necessarily dispositive in every case where the question arises as to whether the proceeds from

a conveyance of rights therein shall be treated as capital gain or as ordinary income for tax purposes. Cf. United States v. White, 10 Cir., 311 F.2d 399. It is the substance and effect of the entire transaction which must be examined. United States v. Foster, supra. Here, the oil production payment was wholly separate and distinct from the royalty interest, neither being dependent upon, carved out of, or affected by the other, save that separate interests had been reserved by taxpayers out of their entire interest in the oil in place prior to the lease. Cf. Herndon Drilling Co., 6 T.C. 628, 637. The sale of the oil production payment is a complete disposition of interest and may not properly be characterized as a mere present assignment of anticipated future ordinary income as in Wiseman v. Halliburton Oil Well Cementing Co., 10 Cir., 301 F.2d 654, and Dyer v. C.I.R., 10 Cir., 294 F.2d 123. Cf. United States v. White, supra; United States v. Dresser Industries, Inc., 5 Cir., 324 F.2d 56; Caldwell v. Campbell, 5 Cir., 218 F.2d 567. The sale of each undivided half of the oil production payment constituted a complete disposition of taxpayers' entire property interest therein and therefore was a sale of a capital asset under 26 U.S.C. § 1221.

The District Director further contends that even if taxpayers' oil production payment is treated as a capital asset, the taxpayers nevertheless are not entitled to long-term capital gain treatment because the oil production payment, created by the lease of November 5, 1956, was not held for six months before it was sold. It is stipulated, however, that the property from which the oil production payment was created had been owned by taxpayers for several years prior to the sale of the oil production payment. The execution of the oil and gas lease providing for the oil pro-

duction payment created no new rights in the taxpayers. United States v. Foster, supra., Fn. 8. Cf., Alice G. K. Kleberg, 2 T.C. 1024, 1031. Under these circumstances, the six month holding period required by 26 U.S.C. § 1222 was satisfied and the taxpayers are entitled to treat the proceeds from the sale of the oil production payment as long-term capital gain.

AFFIRMED.

JUDGMENT

Before MURRAH, Chief Judge, and PICKETT and HICKEY, Circuit Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Oklahoma and was argued by counsel.

On consideration whereof it is ordered and adjudged by this court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

Dated: July 5, 1967.

U.S. GOVERNMENT PRINTING OFFICE: 1967